Supreme Court, U.S.
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No. OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

UNITED TECHNOLOGIES CORPORATION
PRATT & WITNEY,
Petitioner,

v.

DONALD H. RUMSFELD, SECRETARY OF DEFENSE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Is it proper for the court of appeals to rule on a legal issue not raised, briefed or argued on appeal, and not addressed in the agency decision under review?

2. In light of this Court's longstanding directive that when the "United States enters into contract relations, its rights and duties are governed generally by the law applicable to contracts between private individuals," did the Federal Circuit correctly hold that government contracting officials acting within the scope of their authority "may not be estopped on the same terms as any other litigant," but only on a showing of "affirmative misconduct"?

3. Did the Federal Circuit correctly hold that the method by which accountants would interpret the term "cost" and apply it to a transaction *i.e.*, by examining the transaction's economic substance, is irrelevant in applying accounting rules incorporated into government contracts, and that only the Government, not a private contractor, can rely on the economic substance of a transaction to determine proper accounting treatment?

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Petitioner United Technologies Corporation, Pratt & Whitney, states that it has no corporate parents (Pratt is an unincorporated division within United Technologies Corporation). There are no publicly held companies that own more than 10% of United Technologies Corporation's stock.

PARTIES TO THE PROCEEDINGS

All parties to proceedings below subject to this petition for writ of certiorari are set forth in the caption of the petition.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner United Technologies Corporation, Pratt & Whitney ("Pratt") respectfully petitions this Court to issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The January 15, 2003 opinion of the United States Court of Appeals for the Federal Circuit, reversing the decision of the Armed Services Board of Contract Appeals ("ASBCA" or "Board"), is reported at 315 F.3d 1361 (Fed. Cir. 2003) and reprinted at App. A. The Federal Circuit's April 23 order denying rehearing and rehearing *en banc* is reprinted at App. B. The July 31, 2001 ASBCA decision sustaining Pratt's position is reported at 01-2 BCA ¶ 31,592 and is set forth at App. C.

JURISDICTION

The circuit court entered its opinion and judgment on January 15, 2003. Petitioner timely sought rehearing on March 5, 2003. This Petition is filed within 90 days of the April 23 denial of rehearing. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS

The text of relevant statutory and regulatory provisions is set forth in Appendix D.

STATEMENT OF THE CASE

This petition seeks review of a decision of the United States Court of Appeals for the Federal Circuit reversing a decision of the Armed Services Board of Contract Appeals. The Board found that Pratt had properly accounted under its contracts with the United States for revenue distributions that Pratt made to third parties with which Pratt collaborated on certain commercial jet engine programs. The Federal Circuit reversed the Board decision, reinstating and remanding the Government's claim for reimbursement of $260 million in alleged overpayments to Pratt over a period of more than a decade. Notwithstanding that neither party had raised the issue on appeal, the Federal Circuit panel then prescribed the legal standard it believed applicable on remand to Pratt's contention that the Government is estopped from recovering a large portion of the $260 million.

As set forth more fully below, the Federal Circuit's decision overreaches, procedurally and substantively, in at least three significant ways:

A. The panel summarily and improperly reached out to issue an incorrect ruling on an important legal issue: the standard for applying estoppel against the Government in connection with a government contract. That issue had not been addressed in the decision under review and was not briefed or argued by the parties on appeal. *See* Part I, infra.

B. The panel peremptorily extended the doctrine that "the Government may not be estopped on the same terms as any other litigant" to the field of government contract performance. That extension is in direct conflict with this Court's repeated admonitions to the Federal Circuit that when the "United States enters into contract relations, its rights and duties are governed generally by the law

applicable to contracts between private individuals." *United States v. Winstar Corp.*, 518 U.S. 839, 895 (1996), quoting *Lynch v. United States*, 292 U.S. 571, 579 (1934) (plurality opinion). The Federal Circuit's disregard of this general principle is compounded by its disregard of specific, longstanding precedent expressly mandating that estoppel principles applicable to contracts between private individuals apply to the Government's performance of its contractual responsibilities. The notion that a contractor, who relies to its detriment on the Government's approval of its performance under a government contract, should bear the financial burden if the Government turns out to be wrong in granting that approval, is not reconcilable with basic contractual fairness and mutual obligation. *See* Part II, infra.

C. The panel rejected reliance on accounting expertise and economic substance to determine the proper accounting treatment of the transactions in question. It substituted an "ordinary" meaning for the factual inquiry into economic substance that the Board found accountants would use. In so doing, the panel departed from the basic precept that specialized terms in a regulation – especially when incorporated in a contract – are to be understood and applied as they would be understood and applied by the profession to which they are directed. The panel's formalistic approach to cost accounting is inconsistent with basic accounting objectives, established accounting principles, and this Court's (and its own) precedents on the primacy of economic substance over form. Ironically, the panel champions its form over substance approach at a time when the accounting profession is under attack for too often allowing transactions to be classified in a way that fails to reflect economic substance. See Part III.

Precisely because the Federal Circuit's jurisdiction over appeals in government contract cases is exclusive (*see* 28 U.S.C. § 1295(a)), its abrupt departures from settled principles of government contract law, in each instance markedly skewing the law to favor the Government's position, will not be tempered by the views of other circuits addressing similar issues. Without action by this Court, the Federal Circuit's pronouncements become the final authority on matters of government contract law, irrevocably affecting day-to-day performance under thousands of government contracts. The Federal Circuit's departures from precedent – this Court's, its own, and that of its predecessor court – create uncertainty, lack of reciprocity, and unfairness in a field in which certainty and mutuality of obligation are imperative. Given the significance of the Federal Circuit's departures from precedent and procedure in this case, this Court should grant this petition for certiorari.

STATEMENT OF FACTS

The underlying contract issue presented by this case concerns the accounting treatment of revenue distributions that Pratt makes to firms with which it collaborates in connection with certain commercial jet engine enterprises. The Government sought to characterize those revenue distributions as a cost of materials, likening them to a simple purchase of materials from vendors. Pratt maintained, and the Board found, that these were, in fact, distributions of revenue to risk-bearing co-venturers in a common enterprise. The issue has important implications for the amounts that the Government owes Pratt under its government contracts. The Government's claim here was for $260 million. The issue arose as follows:

Contractual and Regulatory Background

The Armed Services Board of Contract Appeals is authorized to adjudicate contractual disputes arising between the United States and its contractors. 41 U.S.C. § 607(d). In this case, the Board's jurisdiction over Pratt's contracts with the United States required it to determine whether the Government had properly reimbursed Pratt for overhead costs allocated to various government contracts. The Government sought, in essence, a refund of sums paid to Pratt over more than a decade, claiming *inter alia*, $260 million in overpayments and interest on various contracts. To resolve the contractual issue, the Board was required to determine whether Pratt's accounting for revenue distributions to third parties collaborating with Pratt on various commercial jet engine programs is consistent with the Cost Accounting Standards incorporated in Pratt's contracts.

The Cost Accounting Standards, known as "CAS," are a set of accounting standards. They are set forth in Part 9904 of Title 48 of the Code of Federal Regulations and incorporated by reference as contract terms in certain contracts and subcontracts with the United States (*i.e.* where the price negotiated or paid is, in whole or part, based on the contractor's actual or estimated costs). Those standards were drafted by the congressionally-created Cost Accounting Standards Board, 41 U.S.C. § 422, composed of experts in cost accounting.[1] CAS standards are incorporated in

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[1] The Cost Accounting Standards Board is composed exclusively of persons who "have experience in Government contract cost accounting." 41 U.S.C. § 422(a)(1).

thousands of federal contracts, including virtually all of Pratt's.

Factual Background

Pratt manufactures and sells engines for commercial and military aircraft. The development of a new commercial aircraft engine entails enormous investment, typically in excess of a billion dollars. That investment involves risks that there will be no return on the investment absent significant sales. Thus, starting in the 1970's, in order to defray a portion of the expenses and risks of three major commercial engine programs, Pratt began entering into long-term strategic alliances (called "collaboration" agreements) with various companies.

Each of the collaborating companies pays a very large initial entry fee commensurate with a percentage share of the program(s) it joins. It assumes the same percentage share of ongoing program risks, losses and expenses.[2] As the program proceeds into production and sales, each strategic ally shares in overall program revenue and must meet expense reimbursement and other obligations, including contributing manufactured parts and components, all commensurate with its program share.

Under these arrangements, no payment is due to a collaborating company unless and until revenue is actually

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[2] The court of appeals noted examples of the collaborators' "risk sharing":

> sharing in the risk that the engine program would lose money; sharing in the administrative expenses for the engine programs; sharing in price discounts and rebates to customers; sharing in liability to third parties . . .

315 F.3d at 1365.

received from the sale to a commercial customer of an engine or spare part that is part of the program. Under the collaboration agreements, Pratt is responsible for program sales, and upon Pratt's receipt of program revenue, it passes to each program collaborator its proportionate share. Most sales are of spare parts, rather than engines, but each collaborator receives its program share of all revenue, whether or not it supplied the parts that were sold.

Pratt does not treat the revenue distributions to collaborators as a cost to Pratt of purchased materials, nor does Pratt treat engine parts manufactured by collaborating companies as Pratt assets; rather, title remains with the collaborators and passes through Pratt only at the instant of sale to a customer. Pratt holds the collaborator-produced parts and accounts for them as consigned goods. In marked contrast, when Pratt purchases a jet engine part from a subcontractor, Pratt pays the purchase price of the part, Pratt accounts for the payment as a cost, the part becomes an asset on Pratt's books, and the subcontractor gets nothing when the part is sold (and is paid regardless of whether or not the part is sold). Pratt's strategic allies bear enormous program risk along with Pratt; subcontractors and vendors do not.

The Government's financial interest in this matter is directly affected by this accounting treatment. If collaborator parts were "purchased" as from a subcontractor, government accounting rules applicable to Pratt (*viz.*, CAS 410, 418, and 420) would require that the cost for the parts be used in calculating overhead rates used in pricing most of Pratt's government contracts (*i.e.*, those where prices are based on actual or estimated cost). Because Pratt did not account for the collaborator parts as having been purchased by Pratt, and because those parts were used or sold in the performance of commercial engine program contracts, the amount of overhead expense allocated to commercial

contracts was less than – and the amount allocated to government contracts more than – it otherwise would have been. The result of this greater allocation of overhead to government (as opposed to commercial) contracts is greater cost to the Government.

The Government fully understood Pratt's allocation practice and its impact on pricing government contracts. As the first collaboration programs reached their production phases in the early 1980's, Pratt explored various possible methods of accounting for parts provided by collaborators. These efforts culminated in a draft Cost Accounting Standards disclosure statement submitted to the Government in 1984. In it, Pratt proposed to allocate portions of its overhead to all "consigned material," including both material received from the Government and from collaborators. Ultimately, after audits and reviews of Pratt's submissions, the Government's responsible contracting officials, including the Defense Contract Audit Agency, advised Pratt that allocating overhead to the consigned parts was *not required* by CAS. Pratt told the Government that it intended to maintain its practice of allocating overhead only to materials purchased from vendors, treating its revenue share distributions to collaborators as pass-throughs of revenue to the collaborator entitled to the revenue and not as costs of purchased materials. In 1987, the responsible contracting officials twice approved Pratt's accounting treatment.

In 1992, the Government reversed course. The government's contracting officer decided that, because collaborator parts caused overhead expense to be incurred, Pratt was required to include the collaborators' revenue share of sales in Pratt's cost base of purchased materials, to which indirect costs (*i.e.* overhead) are allocated. Treating revenue shares as part of the material cost base would reduce the overhead allocated to Government contracts. In 1996, the

Government reformulated its position. The Government adopted the view that collaborator parts had been purchased by Pratt because the "collaborators [were] in essence subcontractors or vendors to [Pratt]." 315 F.3d at 1367. Under this theory, the Government asserted a contractual claim against Pratt for the alleged financial impact on the Government of Pratt's allocation practices through 1995.

The Decision of the Armed Services Board of Contract Appeals

Pratt appealed to the Armed Services Board of Contract Appeals, asserting that its accounting fully complied with CAS (and thus with its contracts). Pratt also asserted that the Government was precluded from retroactively reneging on its approval of the accounting practice in 1987. Thus, (Pratt argued) even if the Government were correct on the substantive accounting point, the Government should not be permitted to recover payments for the period during which Pratt had reasonably relied on the responsible contracting officials' approval of its accounting. The Government, for its part, asserted that "the form of the transaction governed" (315 F.3d at 1367) and that Pratt owed it $260 million through 1995, arising from Pratt's failure to treat revenue distributions as costs of purchased materials.

On July 30, 2001 after an 11-day hearing during which the Board heard the testimony of twelve fact and seven expert witnesses, the Board issued a 57-page opinion. The Board held that Pratt's accounting treatment of the revenue distributions complied fully with CAS. App. C.

The Board noted a government report addressing the fact that CAS did not set forth clear rules regarding the accounting for new types of strategic alliance and joint venture relationships. App. C at 74a. In particular, it

recognized (as did the Government and Pratt) that CAS does not set forth a specific standard directed to the question whether revenue distributions to stakeholders in these circumstances are properly classified as "costs." In these circumstances, consistent with Federal Circuit precedent and the Federal Acquisition Regulation ("FAR"), 48 C.F.R. § 31.201-1(a), the Board held that it was appropriate to interpret and apply CAS in accordance with generally accepted accounting principles ("GAAP"). App. 94a. The Board held that under GAAP, "economic substance of the relationship should determine the accounting." App. 100a.

The Board considered testimony of experts in organizational economics and cost accounting to determine how accountants would classify Pratt's collaboration transactions: either as distributions of revenue to stakeholders in a common enterprise or as a purchase of parts from a vendor for a price.

Based on the evidence, the Board found that the collaborations themselves were, in economic substance, joint ventures or strategic alliances, not subcontracts. The Board adopted expert testimony that:

> Pratt's practice of not treating revenue share distributions as a cost is in accordance with widely accepted cost accounting concepts and practices and it also abides by generally accepted accounting principles. It best portrays the economic substance of the existing relationships among entities, their transactions, and their bearing of economic risks and rewards.

App. C at 87a, 100a.

Having ruled for Pratt, the Board had no need to, and did not, rule on Pratt's assertion that the authorized contracting officials' acceptance of Pratt's accounting approach estopped

the Government from retroactively recovering overpayments with respect to Pratt's pre-1992 accounting.

The Federal Circuit Decision

A panel of the United States Court of Appeals for the Federal Circuit (per Dyk, J.) reversed. The panel rejected as irrelevant the Board's inquiry and dismissed its factual findings about the economic substance of the transactions. The panel likewise rejected as irrelevant (a) the expert testimony addressing factors to be considered in determining the economic substance of the transactions (315 F.3d at 1369), (b) generally accepted accounting principles (*id.* at 1373), and (c) case law of this Court and its own court calling for an inquiry into economic substance in resolving a question of economic classification (*id.* at 1376).

Instead, the panel sought an "ordinary" meaning of the word "cost." It began with the dictionary. *Id.* at 1370. The dictionary was consistent with the parties' views of the meaning of "cost" – *i.e.*, something given up in exchange. *Id.* The panel equated an exchange with a "purchase." Finding "purchase" not defined in "standard dictionaries" with "any precision," the panel turned to a legal source, the Uniform Commercial Code, stating that "to determine whether there has been a purchase, we look to see whether there has been a sale."[3] *Id.* at 1371. Under the UCC, a sale "is the passing of title . . . for a price." *Id.* The panel thus found that "cost" as used in CAS is "clear and unambiguous." *Id.* at 1372. It then held that, if the elements of this "passing of title" test are formally satisfied, this *ipso*

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[3] There is, of course, no suggestion that the UCC applied to Pratt's government contracts, let alone to the accounting issue presented.

facto creates a cost, irrespective of the economic substance of the transaction and relationship between the parties.

Although Pratt does not take title to collaborator-manufactured parts when delivered to Pratt, the panel found the requisite "passing of title" in the momentary passage of title *through* Pratt at the instant when a jet engine, or spare part, is purchased by the customer. In that moment, title flows *from* the collaborator, through Pratt, to the purchaser.

The panel found a "price" for parts in the fact that, despite having other continuing obligations, fulfilling its obligation to provide parts is necessary for a collaborator to maintain its right to share in program revenue. *Id.* at 1371. The panel equated the perpetuation of a collaborator's continued right to receive revenue to be a price Pratt pays in connection with the "transfer of title," thereby creating a "cost." *Id.* at 1372.

The panel defended its form-over-substance tack as promoting consistency, preferring a narrow focus on the presence of a single aspect of the transaction – the instantaneous passing of title through Pratt – as preferable to "amorphous" factual inquiries into economic substance. The panel found no "meaningful guidance" in the concept of accounting for a transaction according to its economic substance. *Id.* at 1375.

The panel noted that the Board had not decided whether the Government was estopped from asserting that "the revenue payments for parts acquired under the collaboration agreements did not constitute costs." *Id.* at 1377. Neither Pratt nor the Government raised that issue on appeal. The panel nonetheless instructed the Board that "[a]djudication of the estoppel issue must proceed under the 'well settled [rule] that the Government may not be estopped on the same terms

as any other litigant.'" To prevail, "Pratt must show 'affirmative misconduct'" by the Government. *Id.*

Pratt timely sought rehearing and rehearing *en banc*. Those requests were denied on April 23, 2003. App. B.

REASONS FOR ISSUING THE WRIT

I. This Court Should Exercise Its Supervisory Authority to Preserve the Principle that Appellate Courts Should Not Resolve Important Issues Not Addressed Below and Not Raised on Appeal

In directing the Board on the legal standards to govern "[a]djudication of the estoppel issue" on remand, the panel departed from accepted, ordinary, salutary rules governing appellate procedure and jurisdiction. The panel acknowledged that the Board had not decided the issue. 315 F.3d at 1377. Neither side raised it on appeal. The panel nonetheless summarily instructed the Board on the legal standard to apply.

In so directing – without benefit of briefing or argument – the panel improperly extended to the government contract setting estoppel principles developed to cover the actions of the Government acting as sovereign. *See* Section II *infra*. By contrast, when the Government enters into a contract, this Court has repeatedly held that the Government's actions are judged by the same general legal standards applied to private parties under their contracts. *Id.* Here, the Federal Circuit has announced a major departure from a basic legal principle without even entertaining briefing or argument by the parties.

Federal courts are dependent on the adversary process to guide them in reaching the right result. Without the assistance of the adversary process, a court has only its own information and beliefs to assist it in finding the proper legal

rule. *See United States v. Burke*, 504 U.S. 229, 246 (1992) (Scalia, J., concurring) ("The rule that points not argued will not be considered is more than just a prudential rule of convenience; its observance, at least in the vast majority of cases, distinguishes our adversary system of justice from the inquisitorial one"); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 195 n.4 (1994) (Stevens, J., dissenting) ("the adversary process functions most effectively when we rely on the initiative of lawyers, rather than the activism of judges, to fashion the questions for review") (quoting *New Jersey v. T.L.O.*, 468 U.S. 1214, 1216 (1984)). The "premise of our adversarial system is that appellate courts do not sit as self-directed boards of legal inquiry and research, but essentially as arbiters of legal questions presented and argued by the parties before them." *Carducci v. Regan*, 714 F.2d 171, 177 (D.C. Cir. 1983) (especially inappropriate to address issues not argued where "important questions of far-reaching significance are involved"). A decision rendered without opportunity to be heard runs headlong into basic notions of fair process.

The panel's error in issuing its directive to the Board without briefing or argument is compounded by the fact that the Board itself had not decided the issue. "It is a general rule, of course, that a federal appellate court does not consider an issue not passed upon below." *Singleton v. Wulff*, 428 U.S. 106, 120 (1976). This case falls within no exception to that principle: This is not a case in which the "proper resolution is beyond any doubt" or "injustice might otherwise result" if the appellate court did not address the issue immediately. *Id.*; *Hormel v. Helvering*, 312 U.S. 552, 557 (1941) (describing an "exceptional case . . . where injustice might result [if the court failed] to consider

questions of law neither pressed nor passed upon by the court or administrative agency below").

Moreover, in those limited circumstances where a circuit court may reach an issue not raised by the parties, this Court has strongly advised the circuit courts to request supplemental briefing. *Trest v. Cain*, 522 U.S. 87, 92 (1997). Here, the court of appeals panel did not solicit Pratt's views on the estoppel issue before issuing its direction to the Board.[4] The rule it imposed was anything but "beyond doubt."

The panel's direction to the Board about how "[a]djudication of the estoppel issue must proceed" is not like the permissible instruction that this and other appellate courts occasionally issue to subordinate tribunals to *consider* the implications of some recent case or legal principle. Here, in contrast, the court of appeals preempted the Board's *consideration* of the legal issue by telling the Board in advance what the proper legal standard for judging estoppel should be. In so doing, the panel departed from the "accepted and usual course" of judicial proceedings.

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[4] To be sure, an appellate court may in unusual cases dispose of an appeal on some grounds not argued without requesting further briefing. *Trest*, 522 U.S. at 92 ("We do not say that a court must always ask for further briefing when it disposes of a case on a basis not previously argued."). Unlike *Trest*, this is not a case in which the appellate court *disposed* of an appeal on a ground not argued or raised. This was not an argument (such as the procedural default in *Trest*), that was arguably quasi-jurisdictional, logically considered before addressing the merits – and thus overlooked by the lower court in its silence. The Board had not overlooked the estoppel issue; it simply did not have occasion to reach it. There can be no suggestion that the panel was correcting error by ruling on the estoppel issue itself.

This Court's rules provide that departures from the usual course of judicial proceedings are subject to the Court's supervisory powers through certiorari jurisdiction. S.C.R. 10(a). The departure here is patent and (if the Court is not inclined to grant certiorari on the remaining questions presented) properly addressed here by summary reversal to avoid the pernicious effect of an ill-considered ruling that (because of the Federal Circuit's exclusive jurisdiction over government contract disputes) will have a lasting and pervasive effect on the rights of contractors under their contracts with the United States.

II. This Court's Review Is Required to Assure that the Federal Circuit's Standard for Estoppel Is Consistent with the Decisions of This Court

The Federal Circuit's direction to the Board on the issue of estoppel – far from being "well-settled" – ignores longstanding precedent and foundational principles stated by this Court with respect to the Government's obligations when it contracts with a private party. The Federal Circuit panel erred in summarily extending to a contract setting an "affirmative misconduct" estoppel rule from a case involving "a claim for payment of money from the Public Treasury contrary to a statutory appropriation." 315 F.3d at 1377 (citing *Zacharin v. United States*, 213 F.3d 1366, 1371 (Fed. Cir. 2000) (*citing OPM v. Richmond*, 496 U.S. 414, 424 (1990))). The rule cited by the panel requiring affirmative misconduct is applied only where the Government is acting as sovereign and has not waived its immunity.

The panel directed that "[a]djudication of the estoppel issue [on remand] must proceed under the 'well settled [rule] that the Government may not be estopped on the same terms as any other litigant.'" 315 F.3d at 1377. Therefore, "Pratt must show 'affirmative misconduct as a prerequisite for

invoking equitable estoppel against the government.'" *Id.* (*citing Zacharin*, 213 F.3d at 1371 (emphasis added)).

In direct conflict with the Federal Circuit's statement, this Court's precedents set forth the overarching principle that:

> When the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private individuals.

Mobil Oil Exploration & Producing SE, Inc. v. United States, 530 U.S. 604, 607 (2000) (*citing United States v. Winstar Corp.*, 518 U.S. 839, 895 (1996)); *Perry v. United States*, 294 U.S. 330, 352 (1935) ("When the United States . . . makes contracts, it has rights and incurs responsibilities similar to those of individuals who are parties to such instruments. There is no difference . . . except that the United States cannot be sued without its consent."). "The United States does business on business terms." *United States v. National Exch. Bank of Baltimore*, 270 U.S. 527, 534 (1926).

Under this Court's cases, the rule subjecting the Government to the same contractual standards as private contractors extends to equitable doctrines. This Court specifically held more than a century ago that when the Government enters into a contract, it subjects itself to the application of laches, because when the Government "comes down from its position of sovereignty and enters the domain of commerce, it submits itself to the same laws that govern individuals there." *Cooke v. United States*, 91 U.S. (1 Otto) 389, 398 (1875). *See also Clearfield Trust Co. v. United States*, 318 U.S. 363, 369 (1943) (laches applies against the Government in a contract setting).

The United States has waived sovereign immunity in connection with most of its contracts. By entering into a contract, the Government states its consent to be bound on matters of performance based on mutually-enforceable covenants. Relieving the Government from the consequences of its actions in the course of contract performance would undermine the mutuality that is the foundation of contract law. The ruling of the Federal Circuit in this case thus disregards this Court's clear instruction in *Mobil Oil Exploration*, *Winstar*, and many other cases that the Government is held to the same standards as a private party in performance of its contracts. At the very least, that is the presumptive rule – here simply ignored by the panel.

The panel's departure from the foundational principles set forth in *Winstar* and *Cooke* is exacerbated here by its disregard of specific, longstanding precedent on the application of estoppel. Those precedents applying estoppel against the Government come from the Federal Circuit's predecessor court (which bind the Federal Circuit[5]), and earlier cases of the Federal Circuit itself. Consistent with the historic rule reflected in *Winstar*, it has long been held that if the contractor relied to its detriment, the Government is bound by regulatory interpretations and approvals of a contracting official acting within the scope of his or her authority, even if it is later determined that the official's interpretation was mistaken.

For example, *Litton Systems, Inc. v. United States*, 449 F.2d 392 (Ct. Cl. 1971), decided by the Federal Circuit's predecessor court, expressly held that the government could

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[5] *South Corp. v. United States*, 690 F.2d 1368, 1369 (Fed. Cir. 1982).

not require retroactive changes in cost accounting practices previously approved by the contracting officer without first providing reasonable notice that the government would no longer accept the practice. The court so held even though it found that the accounting practice in question failed to comply with an "absolute requirement" of the governing regulation.[6] *Id.* at 398. In *Broad Avenue Laundry & Tailoring v. United States*, 681 F.2d 746, 747 (Ct. Cl. 1982), the Government was estopped because the contractor relied on the contracting officer's interpretation of certain wage rate regulations, which interpretation "though erroneous, was within the scope of [the contracting officer's] authority." *See also USA Petroleum Corp. v. United States*, 821 F.2d 622, 625 (Fed. Cir. 1987) (applying estoppel standards applicable to private parties against the Government in connection with government contract); *Burnside-Ott Aviation Training Ctr., Inc. v. United States*, 985 F.2d 1574, 1581 (Fed. Cir 1993) (estoppel standard of *OPM v. Richmond* "must be limited to claims of entitlement contrary to statutory appropriations" and does not apply in the

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[6] The issues in *Litton* were closely analogous to those here. Litton used a cost of sales base for allocating general and administrative expense. The Government said that Litton should have used a cost input base and that the change should be retroactive. Litton lost on allocation, but won on retroactivity:

> In view of plaintiff's long and consistent use of the cost of sales method with the Government's knowledge, approval and acquiescence, plaintiff was entitled to reasonably adequate notice that the Government would no longer approve the use of that method with respect to the CPFF contracts. Such notice was essential in order to enable plaintiff to recover the additional G&A expense that would be allocable to its fixed price contracts as a result of the shift in accounting methods.

449 F.2d at 401 (citations omitted).

contractual setting). The Federal Circuit is bound by its precedents and those of the former Court of Claims. The Federal Circuit cannot overcome prior precedent simply by ignoring it.[7]

Unconscionably, under the broad rule that the Federal Circuit announced *sua sponte* in this case, the contractor, not the Government, is made to bear the financial risk that the authorized government officials with whom it deals daily in performing its contract erred in applying the Government's own regulations. Absent misconduct, the Government is not bound by authorized approvals and actions over the course of contract performance upon which the contractor reasonably relied if the Government ultimately persuades a court that its prior approval was not consistent with the law.

That this new, and extremely harsh, rule has been announced by the Federal Circuit, which has nearly exclusive authority over government contract claims, enhances its significance because there will be no moderating voice heard from other circuits. The decisions of the Federal Circuit affect daily practice in the workaday

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[7] The Federal Circuit's recently-acquired discomfort in applying equitable doctrines against the Government is evident from *Johnson Management Group CFC, Inc. v. Martinez*, 308 F.3d 1245 (Fed. Cir. 2002). In that case, a Federal Circuit panel barred a contractor from enforcing a negotiated contract clause because the clause was found unlawful. The dissenting judge noted that by finding the illegality to be patent – though not noticed by responsible officials and the contractor – the majority shielded the Government from responsibility for a well-considered contracting decision in circumstances where the law would demand a more equitable result in connection with a private contract. *Id.* at 1261 (dissenting op.) (noting, in the context of estoppel, that "the laws of contract and the rules of fair dealing do not evaporate when the government is a party").

world of government contracting. The only recourse is to this Court now. The panel's new standard for estoppel in a contractual setting creates a one-sided immunity from responsibility for contract interpretation decisions affecting contract performance – leaving the contractor responsible for the Government's mistakes – that affects every government contract and undermines the basic mutuality of obligation upon which those contracts rest, ultimately to the detriment of the Government itself.[8] As this Court has explained, "expanding the Government's opportunities for contractual abrogation" will have the "certain result of undermining the Government's credibility at the bargaining table and increasing the cost of its engagements." *Winstar*, 518 U.S. at 884.

Because of its importance to the commercial interests of the United States and its contractors, this Court has previously recognized the need to determine "the extent to which special rules, not generally applicable to the private contracts govern enforcement of [] governmental contracts . . . ." *Id.* at 860. This Court has similarly recognized that in areas falling within its exclusive jurisdiction, the Federal Circuit's rulings may be "of special importance to the entire Nation." *Cardinal Chem. Co. v. Morton Int'l Inc.*, 508 U.S. 83, 89 (1993). This Court should exercise its certiorari jurisdiction in this case to ensure that the new rule on estoppel which the Federal Circuit peremptorily issued in this case does not stand – at least not without full consideration by this Court.

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[8] "Absent predictable contract rights, the market will either refuse to participate, or, more likely, simply increase the price of participation." *S. J. Amoroso Constr. Co. v. United States*, 12 F.3d 1072, 1080 (Fed. Cir. 1993) (Plager J., dissenting).

III. The Court Below Improperly Rejected the Relevance of Economic Substance in Interpreting the Controlling Contractual Term

Equally serious is the panel's departure from precedent and foundational legal principles in connection with the contract accounting issue presented by the appeal. As with its new rule on estoppel, the Federal Circuit has afforded the Government a prerogative – the right to rely on the economic substance of a transaction to determine its proper accounting – that it has denied to the contractor. Moreover, the panel effectively substituted a cut-and-dried legal test of its own creation for the accounting analysis of economic substance that the Board found that cost accountants would apply in determining whether Pratt had incurred a "cost."

Consistent with precedent and the evidence, the Board held that proper accounting must be determined by the economic substance of a transaction. *See Riverside Research Inst. v. United States*, 860 F.2d 420, 422 (Fed. Cir. 1988) (recognizing a cost in light of "the economic reality of the transaction at issue"). The Board here examined the transactions at issue and all of the terms of the collaboration agreements pursuant to which each collaborating company underwrites a portion of the cost of the engine program it joins, assumes program risks, makes in-kind contributions to maintain its program share, and obtains a percentage of all program revenue. Examining the economic substance of these contracts, the Board found the revenue distributions to the collaborators to be as they were reflected in Pratt's accounts: distributions of revenue to risk-bearing co-venturers. Conversely, they were not payments for parts furnished by a vendor or subcontractor for a price – *i.e.*, not a "cost" of materials.

The court of appeals rejected the Board's reliance on economic substance, instead divining a bright line test which it offered as an alternative to the "amorphous" concept of economic substance. 315 F.3d at 1375. It held that the Board – and, by implication, the parties, over the course of more than a decade – had simply failed to understand the "ordinary meaning" of the word "cost." Invoking the UCC's definition of "sale," the panel held that a cost must be recognized if there is a "passing of title from the seller to the buyer for a price." *Id.* at 1371 (citing UCC § 2-106 (1986)).

The panel then assigned this "passing of title . . . for a price" a broad and ultimately talismanic significance. Notwithstanding the overall long-term, multifaceted risk-sharing relationship between Pratt and the other collaborators, which distinguishes those collaborators from vendors or subcontractors, the fact that title to parts supplied by the collaborating companies passes through Pratt at the instant of sale to the customer was found to mean that Pratt purchases materials.[9] The panel stretched to find a "price" for the collaborators' parts in the fact that a collaborator receives something for supplying the parts, albeit not a "price" in the usual sense: For its provision of a program share of parts (along with many other things, such as reimbursing a share of ongoing expenses), the collaborator perpetuates its existing interest as a stakeholder in the program, and thus its right to its share of revenue. Under the Federal Circuit's approach, if Pratt simply conveyed title to

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[9] The panel incorrectly said that the Board overlooked the passing of title to Pratt. 315 F.3d at 1371. The Board noted that Pratt does not take title at *delivery*, but also recognized that title passes through Pratt "instantaneously" at sale to a purchaser. App. C. The Board was unwilling to give this momentary passing of title controlling weight in light of the larger economic relationship.

the customer as the collaborator's agent, rather than allow title to pass through it, nothing of economic substance with respect to this issue would change, but the result here would be entirely different.

On this paper thin application of a form-over-substance rationale, the Federal Circuit overturned the Board's findings on economic substance and restored the Government's claim that Pratt must repay $260 million for the period 1984-95. That amount does not include whatever claim the Government may make for further years during which, consistent with the Board's decision, Pratt accounted for the transactions according to their economic substance.

The panel's approach to the accounting issue ignores basic principles reflected in this Court's cases: First, it ignores the sensible rule prescribed by this Court that a term employed in a specialized regulation is to be interpreted and applied by practitioners in the trade to which the regulation is addressed. Second, it ignores the commonsense understanding that substance should prevail over form as a matter of accounting and legal analysis.

A. The Panel Sought to Derive an Ordinary, Legal Meaning for a Term that, as Applied, Requires a Specialized, Professional Meaning

Courts presented with contract disputes are often asked to address accounting questions, particularly when an accounting term or concept is incorporated in a contract. But a court judges the accounting question with attention to its provenance as an accounting rule or principle. It is a familiar principle under "the law applicable to contracts between private individuals" (*Winstar*, 518 U.S. at 895) that contracts are interpreted according to customs and usages of the trade to which they are addressed.

The Cost Accounting Standards incorporated in Pratt's contracts are *accounting* standards. They were developed and promulgated by the CAS Board, a prototypical expert agency, comprised of persons "experienced in government contract cost accounting." 41 U.S.C. § 422. They use terms and concepts familiar to the accounting profession for application in practicing that profession.

Where a statute uses words in a specialized, professional context, it is improper to assign those words their "ordinary meaning." *See Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 371-72 (1986) ("technical terms of art should be interpreted by reference to the trade or industry to which they apply"; "charges," "classifications," and "practices" are words used by accountants, regulators, courts, and commentators to denote depreciation treatment); *United States v. Buffalo Natural Gas Fuel Co.*, 172 U.S. 339, 341 (1898) ("words are to be taken in their commonly received and popular sense, or according to their commercial designation, if that differs from the ordinary understanding of the word"). *See O'Leary v. Brown-Pacific-Maxom, Inc.*, 340 U.S. 504, 507-08 (1951) (rejecting plain meaning for "standards are not so severable from the experience of industry nor of such a nature as to be peculiarly appropriate for independent judicial ascertainment as 'questions of law'").

Corning Glass Works v. Brennan, 417 U.S. 188 (1974), addressed the term "working conditions." This Court noted that, "while a layman might well assume that time of day worked reflects one aspect of a job's 'working conditions,' the term has a different and much more specific meaning in the language of industrial relations." *Id.* at 202. The specialized meaning controlled. Where a statute uses "technical words or terms of art, 'it (is) appropriate to

explain them by reference to the art or science to which they (are) appropriate.'" *Id.* at 201 (citing *Greenleaf v. Goodrich*, 101 U.S. 278, 284 (1880).

Specialized usage should have controlled here: The essence of the accounting task is to portray transactions according to their economic substance. "Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance." App. C at 36a (citing AICPA Statement of Auditing Standards No. 69); see also App. C at 40a (citing APB Statement No. 4)("Sometimes, however, substance and form differ. Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented."). Indeed, the Government instructs its own auditors to examine substance, not merely form: "Determine not only the form of the business organization but the actual relationship (substance) between the venturing contractors." Defense Contract Audit Agency, Contract Audit Manual § 7-1807 (Jan. 2003).

Economic substance is particularly important in characterizing new forms of business organization and novel transactions. While CAS (like GAAP) prescribes specific standards for certain transactions, nothing in CAS addresses distributions of revenue to risk-sharing entities that maintain an ongoing share in the overall enterprise through in-kind contributions, like those at issue here. Indeed, the tortuous path traversed by the appellate panel to arrive at a transfer of title test – and then render it absolute – highlights both that CAS itself sets forth no specific rule and, thus, that the answer to the question presented was to be found by applying general principles of accounting to the facts as found. *See* 48 C.F.R. § 31.201-2.

B. Economic Substance Properly Prevails over Technicalities of Form in Determining Proper Accounting

The Board held that "the economic substance of the relationship should determine the accounting, irrespective of the label attached to it by lawyers, economists, and accountants." App. C at 100a. Indeed, as a general rule, in characterizing transactions, substance *should*, and regularly does, prevail over form. A judicially-supplied *per se* rule that relies on a single criterion is inconsistent with the basic accounting objective of portraying transactions as they really are.

In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), this Court observed that for 50 years it had resolved tax issues by examining "economic realities":

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.

Id. at 573. The panel here distinguished *Lyon* on the basis that while the Government may look behind the form of a transaction and rely on its economic substance, a party to the transaction may not. 315 F.3d at 1376. That proposition may be correct in tax cases, where the Government acts as sovereign. But it has no application where the Government is a contracting party. Just as with the estoppel issue discussed above, the panel has ignored this Court's longstanding instruction that both sides operate under a government contract pursuant to the same rules.

Especially for accounting purposes, economic substance should control. This has been the rule under prior Federal Circuit precedent specifically addressing "cost" under CAS.

In *Riverside*, 860 F.2d 420, the Federal Circuit reviewed a board finding that the contractor had not incurred a "cost." The court there unhesitatingly embraced the concept of economic substance that it denied Pratt here, reversing because "the Board ignored the economic reality of the transaction at issue." 860 F.2d at 422.

The Federal Circuit has elsewhere described "temporary title transfer as a 'technicality." *See Florida Power & Light Co. v. United States,* 307 F.3d 1364, 1373 (Fed. Cir. 2002) (citing *Commonwealth Edison Co. v. United States*, 271 F.3d 1327, 1355 (Fed Cir. 2001) (en banc)). The Federal Circuit suggested no reason why momentary passage of title is an absolute determinant of "cost" here. In contrast, the Board had not allowed the incidental, momentary passage of title to obscure the "economic reality" that these revenue distributions are to profit- and risk-sharing co-venturers that maintain program share by, among other things, in-kind contributions.

The panel suggested that its *per se* rule would achieve "uniformity and consistency," avoiding "amorphous inquiries" into substance. 315 F.3d at 1375. Yet precisely because the rule bars recourse to economic substance, it achieves only false consistency. Because the objective of accounting is, of course, to classify transactions according to their substance, a rule that elevates one formal aspect of a transaction over all others can be misleading. It may be "consistent" to treat all transactions that display a single characteristic alike, but such a rule fails to satisfy the objectives of CAS when the transactions are, in other relevant ways, importantly different.

The panel's formalistic approach rewrites basic accounting in a disturbing way at a most inopportune time. The purpose of accounting is to present a fair picture of a

transaction, enterprise, or organization so that it can be understood in its true economic sense. To allow selective formalism to control the accounting portrayal of a novel transaction distorts the function of accounting, particularly where the financial impact is so dramatic. To be sure, the form and legal technicalities of a transaction usually coincide with its economic substance. But where form and substance do not coincide, the objective of accountancy is, and should be, to reflect economic reality, not illusion. The panel's decision turns accounting upside down. It espouses the wrong message at a time when the accounting profession and industry are being criticized for often allowing a penchant for bright line rules to obscure the duty to report transactions in a way that reflects their economic substance.[10]

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[10] SEC Commissioner Glassman recently commented that:

> The more specific the rules, the easier companies may find it to structure transactions specifically to circumvent them. This, of course, is the problem with "bright line" rules: the impulse is to make sure the line isn't crossed instead of making sure the books reflect the true economic condition of the company. The substance of a transaction should dictate the accounting, not vice versa.

Commissioner Glassman, "Improving Corporate Disclosure - Improving Shareholder Value," 23rd Annual Ray Garrett Jr. Corporate and Securities Law Institute (April 10, 2003) (http://www.sec.gov/news/speech/spch041003cag.htm).

Earlier, the Chief Accountant of the SEC observed:

> Rule-based accounting standards . . . [encourage] a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting. . . . Rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard.
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> . . .

(continued....)

As with the estoppel issue, the Federal Circuit's ruling favoring the Government on this issue upsets well-settled, sensible, legal principles on which companies contracting with the United States have long relied. The Federal Circuit's endorsement of the Government's form over economic substance approach to "cost" here reinstates the Government's claim that Pratt must repay the Government $260 million for overpayments through 1995 (and expectably additional amounts for later years). Moreover, as the Board noted, other contractors employ similar collaboration agreements. App. C at 74a. More generally, the principles that accounting should reflect economic substance, that day-to-day accounting should be based on accounting concepts, and that the testimony of accountants is relevant when disputes over proper accounting arise, have long been relied upon in the field of government contract accounting. This Court should resolve the significant questions presented by the Federal Circuit's approach.

CONCLUSION

The petition for a writ of certiorari should be granted.

(continued) . . .

> An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction.

The Roles of the SEC and FASB in Establishing GAAP: Hearing Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm on Financial Services, 107th Congress (May 14, 2002) (http://www.sec.gov/news/testimony/051402tsrkh.htm).

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